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Client Alert

A report for clients and friends of the firm

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Tipping the Balance for Cash Balance Plan Sponsors Under the New Pension Act and in the Wake of *Cooper v. IBM*

Plan sponsors and fiduciaries are breathing a sigh of relief as a result of two significant developments over the past week that affect cash balance and other hybrid pension plans. First, Congress passed the Pension Protection Act of 2006 (the "Act"), which affirms the legitimacy of these plans on a prospective basis if certain new requirements are met. It is expected that the President will sign the Act within the next few weeks. Second, in a long-awaited decision, the U.S. Court of Appeals for the Seventh Circuit issued its decision in *Cooper v. IBM Personal Pension Plan*, __ F.3d. __ (7th Cir. Aug. 7, 2006), ruling that cash balance plans do not violate the prohibitions against age discrimination under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). For a discussion of other significant developments on the new pension legislation, see http://www.proskauer.com/news_publications/client_alerts/index

Hybrid Plans Generally

Cash balance and other hybrid pension plans are defined benefit pension plans that contain features of both defined benefit plans and defined contribution plans. Many employers have adopted these plans (or converted traditional defined benefit plans into hybrid plans) in order to provide employees with a specified retirement benefit at normal retirement age in an easy-to-understand manner.

Under a cash balance plan, a hypothetical account is established in each participant's name. Each participant is credited with an employer's hypothetical contributions (compensation credits) and hypothetical earnings (interest credits). Employer contributions are usually expressed as a percentage of pay, which may be tied to age and years of service. Interest credits may be at a fixed interest rate, or tied to an extrinsic index. Although compensation credits cease when a participant terminates employment, interest credits continue until the date the pension benefit is distributed to the participant.

Other hybrid plans such as pension equity plans (commonly referred to as "PEPs") provide a benefit that equals a percentage of final average pay, with the percentage based on points earned by the participant each year. Many of the issues raised with cash balance plans (particularly, age discrimination claims) have been raised with PEPs and other hybrid plans.

Under ERISA and the Internal Revenue Code of 1986, as amended (the "Code"), benefits paid from cash balance plans (and other defined benefit plans) must be paid as a life annuity commencing at normal retirement age unless the plan permits benefits to be paid in other forms, such as a lump sum. If a cash balance plan permits benefits to be paid as a lump sum, the plan must calculate a participant's hypothetical account balance at normal retirement age (using the plan's interest credit rate) and then discount that benefit to its present value at the date of distribution (using the statutory interest rate).

Issues Covered By the Act and *Cooper*

The Act addresses on a prospective basis several issues pertaining to cash balance and other hybrid plans, including, without limitation: (i) the rate of benefit accrual; (ii) an interest requirement; (iii) conversions; (iv) vesting; and (v) mergers and acquisitions. The *Cooper* decision, discussed below, only addresses the first of these issues.

Rate of Benefit Accrual

Since 1986, the Code, ERISA and the Age Discrimination in Employment Act ("ADEA") have contained parallel provisions prohibiting age discrimination in benefit accruals under a defined benefit pension plan by providing that "the rate of an employee's benefit accrual may not be reduced, because of the attainment of any age." 29 U.S.C. 1054(b)(1)(H)(i); 26 U.S.C. § 411(b)(1)(H); 29 U.S.C. § 623(i). The plaintiffs' bar contends that cash balance plans violate these statutes even though compensation credits earned by older employees will be equal to or greater than the compensation credits earned by younger employees, because younger employees' pay credits may grow to a larger sum at retirement age due to the additional time in which interest credits accrue.

In fact, dozens of lawsuits have been filed against plan sponsors and fiduciaries nationally asserting this claim as a result of the district court decision in *Cooper*, wherein the court concluded that IBM's cash balance plan was age discriminatory because the projected benefit (at normal retirement age) earned in earlier years by younger people is greater than for older people in light of the accrual from the continued crediting of interest. If universally followed, it would have undermined the legality of all cash balance plans, not just the one sponsored by IBM.

Fortunately for plan sponsors and fiduciaries, the Seventh Circuit reversed the district court's decision in *Cooper* and held that merely because a younger person has more time to accrue interest before normal retirement age (all other things being equal), the cash balance should not be treated as age discriminatory. In so holding, the Court reasoned that the age discrimination provisions for defined contribution and defined benefit plans (as applied to cash balance plans) both essentially make reference to the "contributions" to a participant's account as opposed to the benefit payable from a participant's account. Further, the Court observed that there is nothing in the legislative history to suggest that Congress set out to prohibit plans from providing younger workers, who have statistically more time left before retirement, with the opportunity to earn more interest than older workers.

The Act now makes it clear that hybrid plans will not be treated on a going-forward basis as violating the age discrimination provisions under the Code, ERISA and ADEA if a participant's accrued benefit would be equal to or greater than that of any similarly situated (*i.e.*, identical in every respect except for age) younger individual who is or could be a participant. To achieve this result, these statutes provide that in determining whether a plan is age discriminatory, benefits may be calculated in ways other than as an accrued benefit (*i.e.*, an annuity at normal retirement age), such as by using the balance of a hypothetical account or the current value of the accumulated percentage of the participant's final average compensation.

Interest Requirement

The Act further provides that in order to satisfy the benefit accrual rules, the interest credit under a cash balance or other hybrid plan cannot be at a rate that is greater than a market rate of return. A plan is permitted to provide for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return. Interest credits of less than zero cannot result in a participant's account dropping below the aggregate amount of contributions credited to the account. Special rules concerning the interest rates and mortality tables apply upon a plan termination. Among other things, these rules require the averaging of interest rates over a five-year period ending on the termination date in the case of a plan that uses a variable rate.

Conversions

As part of the conversion from a traditional defined benefit plan to a hybrid plan, some plan sponsors set participants' opening hypothetical account balances below their accrued benefit. The net result is that participants will fail to accrue an increase in benefits until their hypothetical account balance and subsequent accruals exceed their former accrued benefits—that is, the difference "wears away" over a period of time. Although the terms of the plan in these cases provide that a participant would never receive less than the accrued benefit in effect immediately before the conversion, the plaintiffs' bar has argued in several cases that this practice violates the Code and ERISA's prohibition on decreasing a participant's "accrued benefit."

The Act effectively prohibits new hybrid plans from instituting a wear-away insofar as it requires that in a conversion to a cash balance plan, the minimum benefit provided cannot be less than a participant's benefit prior to the conversion plus the benefit earned after the conversion. In calculating the minimum benefit under the converted plan, early retirement benefits and retirement-type subsidies relating to pre-conversion service may need to be included. The Act also calls for Treasury to issue regulations designed to prevent plan sponsors from indirectly implementing wear-away provisions through multiple plans or amendments.

Whipsaw

As discussed above, if a plan permits benefits to be paid in a lump sum, the plan must calculate a participant's hypothetical account balance at normal retirement age and then discount that benefit to its present value at the date of distribution. If the interest rate that applies under the plan is higher than the rate that is used to discount the participant's benefit back to present value (set by the Code), distribution of the amount in the participant's hypothetical account balance causes an impermissible forfeiture under ERISA. This phenomenon is known as "whipsaw." To avoid whipsaw, many plans set the interest crediting rate at the rate equal to or higher than the present value rate, the latter of which causes the distribution of a lump sum to exceed the participant's hypothetical account balance and creates an anomalous result.

Under the Act, the whipsaw problem has been eliminated, so that a hybrid plan may pay out a participant's account balance in a lump sum provided that the plan uses a market rate of interest, as described above. The Act provides for Treasury to issue regulations that will provide rules for calculating a market rate of return. The Act also permits a plan to use a reasonable minimum interest rate without incurring a whipsaw problem.

Vesting Requirement

Under the Act, the cash balance or other hybrid pension plan must provide for three-year vesting with respect to the participant's accrued benefit derived from employer contributions.

Mergers and Acquisitions

No later than twelve months after the Act's enactment, Treasury is directed to issue regulations addressing the application of these rules to cash balance and other hybrid plan conversions covering employees who become employees by reason of a merger, acquisition or similar transaction.

Effective Date

In general, the provisions under the Act are effective on and after June 29, 2005, although the provision relating to minimum value and the directive to issue regulations relating to mergers and acquisitions are effective on the date of the Act's enactment. The interest credit and vesting rules for existing plans generally apply to years beginning after 2007, although an employer may elect to have the rules apply to any period after June 29, 2005. Additional delays may apply for collectively bargained plans.

The Act expressly provides that nothing in it should be construed to infer the treatment of hybrid plans or conversions to such plans under the rules prohibiting age discrimination as in effect before the Act is effective. In addition, no inference is to be drawn with respect to the application of the minimum benefit rules to hybrid plans before the provision is effective.

Implications for Plan Sponsors and Fiduciaries

While the combination of the Act and the Seventh Circuit's decision is certainly a blow to the plaintiffs' bar "rate of benefit accrual" age discrimination claims, it is by no means guaranteed that such claims will not continue with respect to plans in existence prior to the Act's effective date. In fact, both age claims discussed above are on appeal to the Third and Ninth Circuit Courts of Appeal, where the issues will be addressed with respect to cash balance plans in existence before the effective date of the Act.

Further, as the IRS has not issued any determination letters for cash balance plans since its moratorium beginning in September 1999, it is not entirely clear when and under what circumstances the IRS will review submissions for favorable determination letters and issue such letters.

Plan sponsors and fiduciaries should review, with the assistance of counsel, their existing cash balance and other hybrid plans, as well as any conversions to these plans, in light of the changes under the Act.

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Proskauer's Employee Benefits and Executive Compensation Law Practice Group includes over 50 attorneys with significant and diverse tax, executive compensation, and employee benefits law experience.

The Tax Department at Proskauer Rose LLP counsels domestic, foreign and tax-exempt clients in a broad spectrum of tax issues.

The following individuals serve as contact persons with respect to this Client Alert and would welcome any questions you might have:

Howard Shapiro
504.310.4085 – howshapiro@proskauer.com

Robert W. Rachal
504.310.4081 – rrachal@proskauer.com

Myron D. Rumeld
212.969.3021 – mrumeld@proskauer.com

Andrea S. Rattner
212.969.3812 – arattner@proskauer.com

Russell L. Hirschhorn
212.969.3286 – rhirschhorn@proskauer.com

Renata C. Pompa
212.969.3918 – rpompa@proskauer.com